

Number: **201406009**  
Release Date: 2/7/2014

Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact: \_\_\_\_\_, ID No. \_\_\_\_\_

Telephone Number:

Refer Reply To:  
CC:FIP:B02  
PLR-103634-13

Date:  
October 28, 2013

Company =

State A =

This responds to your request for a ruling dated January 16, 2013, submitted on behalf of Company. Company requests a ruling that amounts received from certain original and counteracting hedging transactions described below will not constitute gross income for purposes of the real estate investment trust (REIT) income tests under section 856(c)(2) and (3) of the Internal Revenue Code of 1986 (the Code).

Company, a State A corporation, is a self-administered REIT that primarily owns, acquires, renovates, develops, leases, and manages shopping centers and office buildings nationwide. Company represents that it qualifies and intends to maintain its qualification as a REIT within the meaning of section 856 of the Code.

Company uses both unsecured and secured debt to acquire, redevelop, and carry its real property.

Company's unsecured borrowings are composed of credit facilities and fixed term promissory notes issued to institutional buyers. The credit facilities carry a variable rate of interest and provide Company ready access to funds for repayment of mortgage debt, acquisition of property, and the redevelopment or renovation of existing properties. The promissory notes have fixed maturities and have either fixed or variable rates of interest.

Company's secured borrowings are composed of single property mortgage loans and multiple property mortgage loans. The funds from secured borrowings are used to acquire real property and to repay existing debt. For example, funds from secured borrowings may be used to refinance a maturing mortgage loan, to repay a construction loan, or to repay a credit facility.

The proportion of Company's fixed rate debt to variable interest rate debt changes periodically due to ordinary course activities associated with a business that owns interests in multiple real estate assets. Given the variability in its fixed rate and variable rate debt balances, and its need to anticipate forecasted changes in debt amounts and mix, Company manages its interest rate risk with respect to indebtedness incurred or to be incurred to acquire or carry real estate assets on an aggregate basis. Company states that this approach provides an efficient means of managing its overall interest rate risk.

Company enters into hedging transactions in the normal course of its business to manage risk of interest rate changes or fluctuations with respect to borrowings made or to be made by Company to acquire or carry real estate assets. Company manages its current and forecasted interest rate risk primarily with current and delayed start interest rate swaps with third party counterparties. If a lender of a variable rate mortgage loan so requires, Company will enter into a hedge that places a limit on the interest rate (a "Cap").

Company represents that its original hedges entered into or to be entered into satisfy the requirements of section 856(c)(5)(G) of the Code. Company further represents that its original hedges entered into or to be entered into hedge indebtedness incurred or to be incurred to acquire or carry real estate assets.

Because of the fluctuations of the principal amount outstanding on its floating rate debt, Company may need to adjust the amount of its interest rate hedge from time to time. Under certain market conditions, in order to reduce the notional amount of an interest rate hedge to more closely match Company's current or anticipated indebtedness, Company states that it can be significantly more cost effective to enter into a counteracting, or reversing, hedge hereinafter referred to as a "counteracting hedge," rather than terminating all or a portion of an existing original hedge and entering into a new hedge.

Company may use a counteracting hedge to effect, economically, either a partial or complete termination of an original hedge. An alternative method of reducing an over-hedged position is to eliminate, or close out, the entire notional amount of the original hedge and to enter into a new hedge for a reduced notional amount. This alternative would require Company, however, to make a termination payment with respect to the full notional amount of the original hedge and to incur transaction costs with respect to entering into a new hedge agreement for the reduced notional amount. Depending on market conditions, Company's economic goal may be accomplished at a significantly reduced cost by using a counteracting hedge.

Company represents that any counteracting hedges entered into or to be entered into have satisfied or will satisfy the definition of "hedging transaction" under section 1221(b)(2)(A)(ii) of the Code, and have been or will be clearly identified pursuant to the requirements of section 1221(a)(7).

**Law:**

Section 856(c)(2) of the Code provides that a corporation shall not be considered a REIT unless it derives at least 95 percent of its gross income (excluding gross income from prohibited transactions) from dividends, interest, rents from real property, and certain other items listed in section 856(c)(2).

Section 856(c)(3) of the Code provides that a corporation shall not be considered a REIT unless it derives at least 75 percent of its gross income (excluding gross income from prohibited transactions) from rents from real property and certain other items listed in section 856(c)(3).

Section 856(c)(5)(G)(i) of the Code provides that income from a hedging transaction, as defined in clause (ii) or (iii) of section 1221(b)(2)(A), including income from the sale or disposition of such a transaction, will not constitute gross income for purposes of the 75 percent or 95 percent gross income test to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets, provided that such hedging transaction is properly identified pursuant to section 1221(a)(7).

Section 856(c)(5)(G) of the Code was amended by the American Jobs Creation Act of 2004 to provide for the exclusion from gross income of income from hedging transactions, including income from the sale or disposition of such a transaction, for purposes of the 95 percent gross income test. Pub. L. 108-357 (Oct. 22, 2004). (Prior law had provided that such income was treated as qualifying income, as opposed to being excluded, for purposes of this test). The accompanying legislative history explains that the rules governing the tax treatment of arrangements engaged in by a REIT to reduce certain interest rate risks are

prospectively generally conformed to the rules included in section 1221. H.R. Rep. No. 108-755 at 333 (2004).

Section 1221(b)(2)(A) of the Code defines a hedging transaction as any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Secretary may prescribe in regulations.

Section 1.1221-2(d)(3) of the Income Tax Regulations provides that if a transaction is entered into primarily to offset all or any part of the risk management effected by one or more hedging transactions, the transaction is a hedging transaction.

Section 856(c)(5)(J)(i) of the Code provides that, to the extent necessary to carry out the purposes of this part, the Secretary is authorized to determine, solely for purposes of this part, whether any item of income or gain which (i) does not otherwise qualify under paragraph (2) or (3) may be considered as not constituting gross income for purposes of paragraph (2) or (3).

### **Analysis:**

Company represents that income from the original hedges entered into by Company qualify for the exclusion from gross income provided under section 856(c)(5)(G) of the Code. The requirements of this section are satisfied where, as here represented, an original hedging transaction entered into by a REIT is properly identified under section 1221(a)(7), meets the definitional requirements of a hedging transaction under section 1221(b)(2)(A), and, in the case of an interest rate hedge, is a hedge of indebtedness incurred or to be incurred to acquire or carry real estate assets.

The legislative history accompanying the 2004 amendments to section 856(c)(5)(G) of the Code makes clear the intent of Congress that the REIT hedging rules are generally to be conformed to the rules set forth in section 1221. If properly identified under section 1221(a)(7), as represented, the counteracting hedging transactions entered into by Company also qualify as hedging transactions under section 1.1221-2(d)(3) of the regulations because, as represented by Company, they are entered into to offset all or part of the risk management effected by the original hedging transactions.

Pursuant to the provisions of section 856(c)(5)(J)(i) of the Code, income from a counteracting hedging transaction that qualifies as a hedging transaction under section 1221 may be excluded from gross income for purposes of section 856(c)(2) or (3). Under the facts of this case, excluding the income from these hedging transactions from gross income for purposes of section 856(c)(2) and (3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

**Conclusions:**

We rule that, pursuant to the provisions of section 856(c)(5)(G) of the Code, gross income received by Company from the original hedges described in this letter will not constitute gross income for purposes of section 856(c)(2) and (3), based on the facts and representations submitted.

We also rule that, pursuant to the provisions of section 856(c)(5)(J)(i) of the Code, gross income received by Company from the counteracting hedges described in this letter will not constitute gross income for purposes of section 856(c)(2) and (3), based on the facts and representations submitted.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

David B. Silber  
David B. Silber  
Branch Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)